126

Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

15 May 1984

South Africa: Growing Current Account Deficits [redacted] 25X1

Summary

The South African current account is continuing to record severe deficits following its fall into the red during the last quarter of 1983. Increased governmental expenditures, extraordinarily high levels of spending by consumers, and large imports of corn to make up for drought-reduced harvests have boosted imports. At the same time, the steady erosion of gold prices--from an average of $464 an ounce in the first quarter of 1983 to about $380 so far this year--has reduced foreign exchange earnings despite the boost that Western economic recovery has given to South Africa's non-gold mineral exports. [redacted] 25X1

We believe that Pretoria is increasing foreign borrowing this year even though, in our judgment, economic policymakers feel that South Africa's $15 billion foreign debt is uncomfortably high. The authorities are also trying to curb consumer demand in order to slow imports, relying mainly on high interest rates; the prime rate currently exceeds 20 percent. [redacted] 25X1

This memorandum was requested by Peter Lande, Director of Economic Policy Staff, Bureau of African Affairs, Department of State. It was prepared by [redacted] of the Office of African and Latin American Analysis. Comments and questions are welcome and should be addressed to Chief, Africa Division, ALA, [redacted] 25X1

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Restraints on demand and the continuing drought are likely to force the economy to contract in 1984 for the third consecutive year. The increased demand for non-gold mineral exports and reduced demand for non-food imports (assuming that consumer spending subsides) may bring the current account back to equilibrium by the end of the year. Only a sharp increase in gold prices, which we believe is unlikely this year, would convince policymakers to reduce constraints on economic growth. 25X1

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Causes of the Current Account Deficit

South Africa's $141 million current account surplus in the third quarter of 1983 plunged to an $844 million deficit during October-December because of a rise in imports and a fall in gold earnings, according to preliminary data* (see Figure 1). Strong consumer spending, an increase in oil imports, and drought-induced corn purchases pushed imports up 21 percent in the fourth quarter. During the same period, gold earnings decreased substantially owing to a decline in average gold prices from $410 to $388 an ounce. Press reports indicate that the deficit is continuing at high levels this year. 25X1

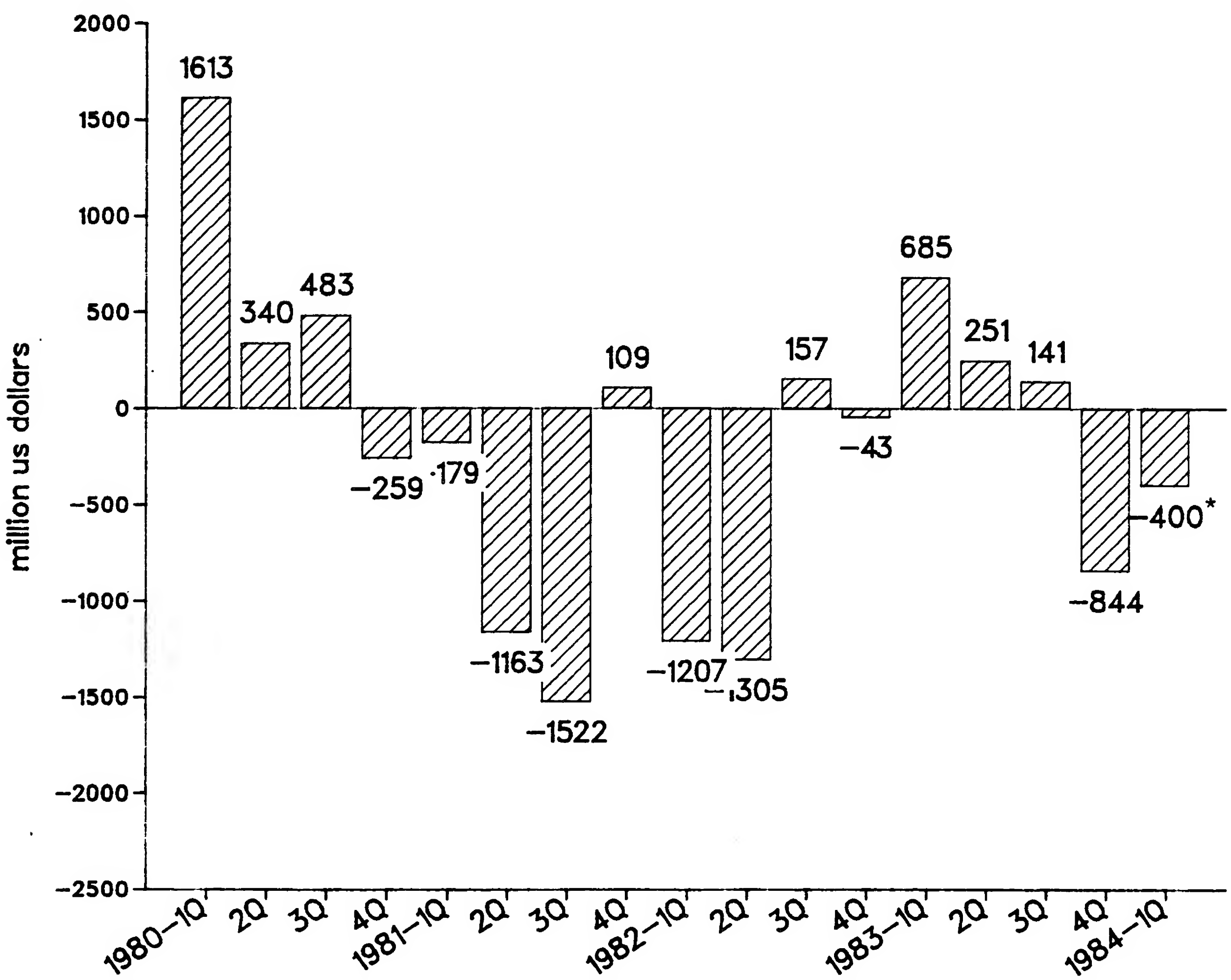
An unusual feature of this current account deficit is that it coincides with economic recovery in the industrial countries and economic depression in South Africa. Historically, these conditions have produced a current account surplus. Economic expansion in the industrial countries has raised the demand for South African exports, while a severe economic downturn in South Africa normally has resulted in reductions in consumer spending that have led to reduced demand for imports. In our judgment, however, the drought, ill-conceived government policies, and high consumer reliance on debt-financed spending have broken these linkages. 25X1

Drought. Before the drought, South African corn exports earned up to $500 million annually. Three successive years of drought, however, have turned corn into a significant import. The total impact on the 1983 current account of losing an average year's corn export earnings and of purchasing 2 million tons of imported corn was $800 million, according to press reports. 25X1

* Except where otherwise indicated, the statistics in this paper were derived from official South African Government publications. 25X1

FIGURE 1

SOUTH AFRICA: Current Account



* Estimated.

This turnaround in agricultural trade largely offset an increasingly strong performance by other major exports during 1983. The value of South Africa's non-gold exports increased during the fourth quarter as a result of three factors: a depreciation of the rand, a rise in international commodity prices, and volume increases for several major exports. Both the value and volume of uranium, coal, platinum, and diamond exports, for example, increased. This performance barely offset the reversal in agricultural trade, however, so that the value of merchandise exports for the full year of 1983 increased by only 2 percent. 25X1

Government Policies. South African policymakers apparently were surprised by the relatively quick return of current account deficits. Based on expectations of good weather and rising gold prices, South African economists had projected early in 1983 that the annual current account surplus would rise to nearly $2 billion. Acting on these optimistic expectations, Pretoria did not increase high interest rates further or cut government spending in 1983. Both actions were needed to put additional constraints on the economy, which already was contracting at an unprecedented rate of almost 4 percent, and thereby to reduce demand for imports. The return to a deficit in the fourth quarter limited the actual surplus in 1983 to only $233 million. 25X1

Consumer Spending. Consumers apparently have been motivated to increase spending during the recession by expectations of increases in the inflation rate and of imminent economic recovery, encouraged in part by optimistic government forecasts. Consumers have compensated for reduced income by borrowing more and saving less. The ratio of savings to after-tax income fell from 3.5 percent in 1982 to a record low 3 percent in 1983. This compares with an average in the 1960s and 1970s of about 10 percent. Borrowing by individuals--including drought-hit farmers--pushed up commercial bank lending to individuals in 1983 by 64 percent over the 1982 level. 25X1

Pretoria's Narrowing Options

In the past, economic policymakers in South Africa have reacted to severe current account deficits in a standard manner: initially selling gold from the government's stock, then using monetary and fiscal tools--higher interest rates and reduced government spending--to constrain economic growth in order to reduce demand for imports. 25X1

Current economic conditions, however, do not afford Pretoria much opportunity to utilize this approach. Economic performance is already negative, and interest rates are at record high levels. South Africa has announced an austere budget for the fiscal year that began this April, but keeping expenditures within budget guidelines probably will prove difficult if the recent pattern of underbudgeting of such items as defense continues. Moreover, the implementation of a new constitution later this

year, which provides for separate parliamentary chambers for Coloreds and Indians, is likely to add to government and bureaucratic costs. Pretoria will be loathe to sell gold from stocks because of the likely impact of any increase in sales on already weak gold prices. 25X1

Outlook

South Africa probably will increase sharply its foreign borrowing in 1984 to avoid draining foreign exchange reserves, which currently total about $1.5 billion.* Under normal circumstances, Pretoria would be likely to request a standby loan from the IMF. We believe, however, that South African officials fear that IMF support for South Africa would be a political liability for the Reagan administration. In our view, Pretoria will avoid any actions that might jeopardize the current tenor of US policy in southern Africa. 25X1

We believe that South Africa will continue to turn to Western banks for increased public and private borrowing. Although economic decisionmakers in Pretoria probably already are concerned about the increase in the country's foreign debt from about $7 billion in 1980 to more than $15 billion at present, South Africa's ratio of debt service to exports is low--between 5 and 6 percent, according to press reports--and its international credit rating is strong. In December 1983, South Africa raised $73 million on European bond markets; in March 1984, according to press reports, it was negotiating for an additional $30 million. In our judgment, Pretoria also will continue to participate in a long-established practice of "swapping" gold with European banks in order to bring in foreign exchange. Under this system, Pretoria sells gold from its stocks at discount prices with a commitment to repurchase the gold in the future at a premium. 25X1

Prospects for regaining a significant current account surplus this year are mixed. Corn imports will continue to be a major drain on foreign exchange. On the other hand, we believe that as consumer indebtedness reaches its limits, consumer spending will begin to decline, resulting in a reduction in the rate of growth in imports. Non-gold exports, moreover, will continue to rise because of growing demand in the United States and other Western countries for South Africa's mineral products. 25X1

Contingency: Increased Gold Prices. The price of gold has fluctuated since the beginning of 1984 between $370 and $400 per ounce. In our judgment, the chances for a significant increase in gold prices are poor so long as the United States and other industrial nations maintain

* In addition, Pretoria's stocks of gold total about 238 tons, which is worth about $2.8 billion at current prices. 25X1

tight control of inflation. Any perceived break in this discipline, however, almost certainly would induce an increase in speculative purchases of gold. Other factors also might drive up gold prices, including a major intensification of the Iran-Iraq war, default by one or more of the principal debtor nations, or a faltering of the US economic recovery. If the price of gold rises sharply in 1984, we believe that the South African authorities will relax their monetary and fiscal restraints enough to allow a slow economic recovery. 25X1

SUBJECT: South Africa: Growing Current Account Deficits

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